

To: National Grid Gas plc (with respect to its gas distribution networks)

(Company Number: 02006000)

Northern Gas Networks Limited

(Company Number: 05167070)

Scotland Gas Networks plc

(Company Number: SC264065)

Southern Gas Networks plc

(Company Number: 05167021)

Wales and West Utilities Limited

(Company Number: 05046791)

("the licensees")

NOTICE UNDER SECTION 23(2) OF THE GAS ACT 1986

The Gas and Electricity Markets Authority ("the Authority") hereby gives notice pursuant to section 23(2) of the Gas Act 1986 ("the Act") as follows:

1. The Authority proposes to modify the gas transporter licences (each "the licence") held by the licensees granted or treated as granted under section 7 of the Act by:
 - (a) amending the following Special Conditions in those licences:
 - 1A (Restriction of revenue in respect of the Distribution Network Transportation Activity: definitions);
 - 1C (Distribution Network allowed pass-through items);
 - 1D (NTS Exit Capacity Cost Adjustment);
 - 1E (Incentive adjustment in respect of the Broad Measure of Customer Satisfaction);
 - 1F (Revenue adjustments for performance in respect of gas Shrinkage and environmental emissions);
 - 1H (The Network Innovation Allowance);
 - 2A (Governance of GD1 Price Control Financial Instruments);
 - 3A (Legacy price control adjustments);
 - 3D (The Innovation Roll-out Mechanism);
 - 3F (Arrangements for the recovery of uncertain costs);
 - 4A (Disapplication of Relevant Special Conditions and Relevant Metering Special Condition);
 - 4G (Methodology for Network Output Measures);
 - 4H (Specification of Network Outputs);
 - (b) amending the GD1 Price Control Financial Handbook ("the handbook") that forms part of Special Condition 2A;
- and

- (c) amending the GD1 Price Control Financial Model ("the PCFM") that forms part of Special Condition 2A.
- 2. Relevant licence holders for the purposes of this Notice are the holders of gas transporter licences granted under section 7 of the Act which contain the Special Conditions referred to above.
- 3. The Authority's reasons for proposing the modifications to the Special Conditions referred to in paragraph 1(a) are:
 - (a) to implement policy decisions in respect of an adjustment mechanism for the NTS Exit Capacity cost allowance that were included in the Authority's Final Proposals for the RIIO-GD1 price control ("RIIO-GD1") that applies to relevant licence holders (see Appendix 1 to this Notice);
 - (b) to implement policy decisions in respect of an adjustment mechanism for the shrinkage allowance that were included in the Authority's Final Proposals for RIIO-GD1 (see Appendix 1 to this Notice);
 - (c) to specify two additional component terms for legacy price control adjustments under RIIO-GD1 to provide for adjustments relating to:
 - i. income adjusting events that occurred in the price control period that preceded RIIO-GD1 ("GDPCR"); and
 - ii. an error that subsisted in the Innovation Funding Incentive mechanism that formed part of GDPCR, (see Appendix 2 to this Notice); and
 - (d) to make additional changes required:
 - i. as a consequence of the proposed modifications described in subparagraphs (a) to (c); and
 - ii. to correct a number of typographical and cross-referencing errors (see Appendix 3 to this Notice).
- 4. The Authority's reasons for proposing the modifications to the handbook referred to in paragraph 1(b) are:
 - (a) to insert a new chapter 11, to set out the methodology for determining the PCFM Variable Values associated with the adjustment mechanisms referred to in paragraph 3(a) and (b);
 - (b) to insert new parts 7 and 8 into chapter 10 to set out the methodology for determining component term values associated with the legacy price control adjustments referred to in paragraph 3(c);
 - (c) to confirm that claw back adjustments to tax liability allowances for relevant licence holders include an iterative ('tax allowance on tax allowance') factor; and
 - (d) to make a number of other corrections and clarifications throughout the handbook so that it is fully consistent with the Authority's Final Proposals for RIIO-GD1.

5. The proposed modifications to the handbook are set out in marked up text in separate Appendix 4 to this Notice.
6. The Authority's reasons for proposing the modifications to the PCFM referred to in paragraph 1(c) are:
 - (a) to add two new input rows to the PCFM Variable Values Table for each Distribution Network (as defined in Special Condition 1A of the licence) relating to the adjustment mechanisms referred to in paragraph 3(a) and (b) of this Notice;
 - (b) to ensure that claw back adjustments to tax liability allowances for relevant licence holders include an iterative ('tax allowance on tax allowance') factor; and
 - (c) to make a number of other amendments and corrections to reflect the proposed modifications to the Special Conditions and handbook referred to in paragraphs 3 and 4 of this Notice,

so that correctly calculated values for the term MOD, as used in the formula for Base Distribution Network Transportation Activity Revenue set out in Special Condition 1B (Restriction of revenue in respect of the Distribution Network Transportation Activity), and having the meaning given in that condition, are produced for each Distribution Network under the Annual Iteration Process for the PCFM.

7. A copy of the PCFM incorporating the proposed modifications is included at separate Appendix 5 to this Notice. A reference copy of the PCFM (without the proposed modifications) is included at separate Appendix 6 to this Notice and a report setting out the changes is included at separate Appendix 7 to this Notice.
8. The effect of the modifications proposed in this Notice will be to amend the licence, handbook and PCFM to:
 - (a) introduce adjustment mechanisms and new PCFM Variable Values for the NTS Exit Capacity cost allowance and the shrinkage allowance for RIIO-GD1;
 - (b) provide component terms for two additional legacy price control adjustments as described in paragraph 3(c) of this Notice; and
 - (c) apply a range of corrections, clarifications and consequential changes,so that the Authority's Final Proposals for RIIO-GD1 are properly implemented.
9. Copies of this Notice and other documents referred to in it are available on the Ofgem website (www.ofgem.gov.uk).
10. Any representations on the proposed licence modifications may be made on or before 30 August 2013 to: Joanna Campbell, Office of Gas and Electricity Markets, 9 Millbank, London, SW1P 3GE or by email to joanna.campbell@ofgem.gov.uk.

11. All responses will normally be published on Ofgem's website. However, if respondents do not wish their response to be made public then they should clearly mark their response as not for publication. Ofgem prefers to receive responses in an electronic form so they can be placed easily on the Ofgem website.
12. If the Authority decides to make the proposed modifications they will take effect not less than 56 days after the decision is published.

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Paul Branston
Associate Partner, Costs and Outputs
Duly authorised on behalf of the
Gas and Electricity Markets Authority

24 July 2013

Appendix 1 to the Authority's Notice dated 24 July 2013

Proposed modifications to the Special Conditions of gas transporter licences to provide for adjustments to the NTS Exit Capacity cost allowance and Shrinkage allowance

| Paragraph reference | Proposed modification |
|---------------------|--|
| 1D.3 | Replace definition of AEx_{t-2} with "means the NTS Exit Capacity cost allowance in respect of the relevant Distribution Network for Formula Year t-2 and is derived in accordance with Part D of this condition.". |
| 1D, Parts D and E | <p>Insert new Parts D and E with the following text:</p> <p>Part D: Revisions to the NTS Exit Capacity cost allowance (AEx)</p> <p>1D.8 The opening value of the NTS Exit Capacity Cost allowance for each year of the Price control Period is set out in Appendix 1 of this condition. This value may be revised during the Price Control Period.</p> <p>1D.9 The Licensee may, by notice to the Authority, propose a revision to the NTS Exit Capacity cost allowance for any Formula Year or Formula Years from 2015/16 to 2020/21. In any Formula Year t, when a revision of the NTS Exit Capacity cost allowance is to take effect, the Licensee must have provided such notice in Formula Year t-2.</p> <p>1D.10 A notice provided under paragraph 1D.9 of this condition must:</p> <ul style="list-style-type: none"> (a) be provided by 31 July in any Formula Year; (b) state the revised NTS Exit Capacity cost allowance for the relevant Distribution Network that is proposed and the Formula Years to which the revision relates; and (c) subject to paragraph 1D.11, provide the basis of calculation for the revised NTS Exit Capacity cost allowance. <p>1D.11 The revised NTS Exit Capacity cost allowance must be calculated by multiplying:</p> <ul style="list-style-type: none"> (a) the target volume of NTS Exit (Flat) Capacity at each offtake for the relevant Formula Years, as set out in Appendix 2 of this condition; and (b) the latest publically available forecast of the NTS (TO) Exit Capacity Charge at each offtake for |

the relevant Formula Years, as set out in an NTS Gas Transportation Statement.

Part E: Determination and direction of revisions to the PCFM Variable Value

1D.12 This Part provides for the determination and direction of a revised PCFM Variable Value for the relevant Distribution Network by the Authority for NTS Exit Capacity cost allowance (AEx values).

1D.13 The Authority will determine whether the PCFM Variable Value should be revised for the purposes of updating the forecast of NTS Exit Capacity costs under the provisions of Part D this condition.

1D.14 Determinations under paragraph 1D.13 of this condition are to be made in accordance with the methodology contained in chapter 11 of the GD1 Price Control Financial Handbook.

1D.15 Subject to paragraph 1D.18 of this condition, a revised PCFM Variable Value determined by the Authority in accordance with the provisions of this condition will be directed by the Authority by 30 November following receipt of the notice provided by the Licensee (or as soon as reasonably practicable thereafter). Any direction to revise AEx values for Formula Year t will be made in Formula Year t-2 (or as soon as reasonably practicable thereafter).

1D.16 Before issuing any directions under paragraph 1D.15 of this condition, the Authority will give notice to the Licensee of the revised values that it proposes to direct.

1D.17 The notice referred to in paragraph 1D.16 of this condition will:

- (a) state that the revised PCFM Variable Value has been determined in accordance with this condition; and
- (b) specify the period (which will not be less than 14 days from the date of the notice) within which the Licensee may make any representations concerning the determination of any revised PCFM Variable Values.

1D.18 The Authority will determine the revised PCFM Variable Values having due regard to any representations duly received under paragraph 1D.17 of this condition, and give reasons for its decisions in relation to them.

1D.19 If, for any reason, the Authority does not make a direction required under paragraph 1D.15 of this condition by the date specified in that paragraph, the Authority will direct the values concerned as soon as is reasonably practicable thereafter, consistent with the purpose of paragraph 2B.12 of Special Condition

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| | <p>2B and, in any case, before directing a value for MOD_t for the relevant Distribution Network under that paragraph.</p> <p>1D.20 The application of the mechanisms set out in this condition means that as a consequence of the Annual Iteration Process, the value of the term MOD_t as calculated for Formula Year t for the purpose of Special Condition 1B will result in an adjustment to the relevant Distribution Network's Base Distribution Network Transportation Activity Revenue in a manner that appropriately reflects the relevant Distribution Network's updated forecast of NTS Exit Capacity costs.</p> |
| 1D, Appendix 1 | Replace "1D.3" with "1D.8". |
| 1F.4 | Replace the definition of " $ALSC_{t-2}$ " with "means the amount of the allowance in respect of the Shrinkage cost in Formula Year t-2 for the relevant Distribution Network and is derived in accordance with Part H of this condition;". |
| 1F, Parts H and I | <p>Insert new Parts H and I with the following text:</p> <p>Part H: Revisions to the allowance in respect of Shrinkage costs (ALSC)</p> <p>1F.37 The opening value of the allowance in respect of Shrinkage costs for each year of the Price control Period is set out in Appendix 1 of this condition. This value may be revised during the Price Control Period.</p> <p>1F.38 The Licensee may, by notice to the Authority, propose a revision to the allowance in respect of Shrinkage costs for any Formula Year or Formula Years from 2015/16 to 2020/21. In any Formula Year t, when a revision of the allowance in respect of Shrinkage costs is to take effect, the Licensee must have provided such notice in Formula Year t-2.</p> <p>1F.39 A notice provided under paragraph 1F.38 of this condition must:</p> <ul style="list-style-type: none"> (a) be provided by 31 July in any Formula Year; (b) state the revised allowance in respect of Shrinkage costs for the relevant Distribution Network that is proposed and the Formula Years to which the revision relates; and (c) subject to paragraph 1F.40, provide the basis of calculation for the revised allowance in respect of shrinkage costs. <p>1F.40 The revised allowance in respect of Shrinkage costs must be calculated by multiplying:</p> <ul style="list-style-type: none"> (a) the allowed Shrinkage volume for the relevant Formula Years, as set out in Appendix 2 of this |

condition; and

- (b) the latest publically available forecast of the price of gas for the relevant Formula Years taken from an Approved Market Price Report.

Part I: Determination and direction of revisions to the PCFM Variable Value

1F.41 This Part provides for the determination and direction of a revised PCFM Variable Value for the relevant Distribution Network by the Authority for the allowance in respect of Shrinkage costs (ALSC values).

1F.42 The Authority will determine whether the PCFM Variable Value should be revised for the purposes of updating the forecast of Shrinkage costs under the provisions of Part H this condition.

1F.43 Determinations under paragraph 1F.42 of this condition are to be made in accordance with the methodology contained in chapter 11 of the GD1 Price Control Financial Handbook.

1F.44 Subject to paragraph 1F.47 of this condition, a revised PCFM Variable Value determined by the Authority in accordance with the provisions of this condition will be directed by the Authority by 30 November following receipt of the notice provided by the Licensee (or as soon as reasonably practicable thereafter). Any direction to revise ALSC values for Formula Year t will be made in Formula Year t-2 (or as soon as reasonably practicable thereafter).

1F.45 Before issuing any directions under paragraph 1F.44 of this condition, the Authority will give notice to the Licensee of the revised values that it proposes to direct.

1F.46 The notice referred to in paragraph 1F.45 of this condition will:

- (a) state that the revised PCFM Variable Value has been determined in accordance with this condition; and
- (b) specify the period (which will not be less than 14 days from the date of the notice) within which the Licensee may make any representations concerning the determination of any revised PCFM Variable Values.

1F.47 The Authority will determine the revised PCFM Variable Values having due regard to any representations duly received under paragraph 1F.46 of this condition, and give reasons for its decisions in relation to them.

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| | <p>1F.48 If, for any reason, the Authority does not make a direction required under paragraph 1F.44 of this condition by the date specified in that paragraph, the Authority will direct the values concerned as soon as is reasonably practicable thereafter, consistent with the purpose of paragraph 2B.12 of Special Condition 2B and, in any case, before directing a value for MOD_t for the relevant Distribution Network under that paragraph.</p> <p>1F.49 The application of the mechanisms set out in this condition means that as a consequence of the Annual Iteration Process, the value of the term MOD_t as calculated for Formula Year t for the purpose of Special Condition 1B will result in an adjustment to the relevant Distribution Network's Base Distribution Network Transportation Activity Revenue in a manner that appropriately reflects the relevant Distribution Network's updated forecast of Shrinkage costs.</p> |
| GD1 Price Control Financial Model | Insert two new PCFM Variable Values - see Appendices 5, 6 and 7 to this notice. |
| GD1 Price Control Financial Handbook | Insert additional Chapter 11 – see Appendix 4 to this notice. |

Appendix 2 to the Authority's Notice dated 24 July 2013

Proposed modifications to the special conditions of gas transporter licences to specify two additional component terms for legacy price control adjustments

| Paragraph reference | Proposed modification |
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| 3A.9 | <p>Insert "+ IFIAR + IAEAR" at end of formula for "LAR".</p> <p>Remove "and" at the end of the definition of "CAR".</p> <p>Replace "." with ";" at the end of the definition of "SAR".</p> <p>Insert definition of "IFIAR" as "means the adjustment in respect of errors identified in the formula used to calculate $IFISD_t$, determined in accordance with Part B of this condition; and"</p> <p>Insert definition of "IAEAR" as "means the adjustment in respect of income adjusting events included in the legacy period."</p> |
| 3A.13 | <p>Remove "and" at the end of sub-paragraph (e).</p> <p>Replace "." with ";" at end of sub-paragraph (f).</p> <p>Insert sub-paragraph (g) to say "IFIAR, in accordance with the methodology set out in part 7 of chapter 10 of the GD1 Price Control Financial Handbook; and"</p> <p>Insert sub-paragraph (h) to say "IAEAR, in accordance with the methodology set out in part 8 of chapter 10 of the GD1 Price Control Financial Handbook."</p> |

Appendix 3 to the Authority's Notice dated 24 July 2013

Proposed modifications to the special conditions of gas transporter licences to make consequential changes and corrections

| Paragraph reference | Proposed modification |
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| 1A.4 | Insert new definition for "Daily NTS Exit (Flat) Capacity" as "means NTS Exit (Flat) Capacity which is applied for and registered for a particular Day only in accordance with paragraph 3.1.5 (b) of section B of the Network Code having effect on 1 January 2013;" |
| 1A.4 | Replace lower case letter in "licensee" with upper case in definitions of "Distribution Network Pension Deficit Charge", "Relevant Shipper", "Retail Prices Index" and "Retail Prices Index Forecast Growth Rate". |
| 1A.4 | Correct typographical error by removing "to" in line 2 and correct spelling of "defnined" by removing first "n" in definition of "GD1 Price Control Financial Model". |
| 1A.4 | Replace upper case letter in "Day" with lower case on line 1 of the definition of "NTS (TO) Exit Capacity Charge". |
| 1A.4 | Insert "which" after "NIA project" on line 1 of the definition of "Unrecoverable Expenditure". |
| 1C.8 | Insert "any positive value of " before first mention of "RB _t ". After first "RB _t " replace "have the value of" with "be set to". |
| 1C.13 | Replace lower case letter in "licensee" with upper case. |
| 1C, Appendix 1,2 and 3 | Replace "Licensee" with "Distribution Network" in the header of each table. |
| 1D.7 | Insert ", excluding Daily NTS Exit (Flat) Capacity," after "Capacity" in the definition of "NTSMAE _{v,t} ". |
| 1D, Appendix 1 and 2 | Replace "Licensee" with "Distribution Network" in heading of each table. |
| 1D, Appendix 2 | Remove "node" after "Offtake" in heading of table. |
| 1D, Appendix 2 | Replace "NTSTV _{qv,t} " with "NTSTVE _{v,t} " in heading of table. |
| 1E.3 (b) | Insert "and" at the end of sub-paragraph. |
| 1E.3 (c) | Replace "; and" with "." at the end of sub-paragraph. |
| 1E.4 | <p>Replace "formula and will not exceed the value of one per cent of BR_t or be lower than the value of negative one per cent of BR_t" with "formulae".</p> <p>Replace the formula:</p> <p style="text-align: center;">— —</p> <p>with the formulae:</p> |

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| | <p>, then:</p> $\frac{I_t}{BR_{t-2}}$ <p>, then:</p> $\frac{I_t}{BR_{t-2}}$ <p>After the definition of "I_t" insert the definition of "BR_{t-2}" as "means the amount of Base Distribution Network Transportation Activity Revenue in Formula Year t-2 as derived in accordance with the formula set out in Part C of Special Condition 1B for the relevant Distribution Network."</p> |
| 1E.21 | Replace the "x" "(PRC _t x 50)" and "(POF _t x 10)" with "+" in the formula. |
| 1F.4 | Remove subscript "i" and " " from the formula. Remove definition "i means the relevant Distribution Network". Remove subscript "i" from "ASV _{t-2,i} " and "ALSC _{t-2,i} ". Replace "for each relevant Distribution Network i and derived" with "for the relevant Distribution Network and is derived" in the definition of "ASV _{t-2} ". |
| 1F.5 | Remove subscript "i" and " " from the formula. Remove definition "i means the relevant Distribution Network". Insert "s" in "repect" in the definition of "n". Remove subscript "i" from all occurrences of "SIP _{t-2,i} ", "SOP _{t-2,i} ", "SOP _{t-3,i} ", "SB _{t-2,i} " and "ASV _{t-2,i} ". |
| 1F.7 | Replace "CT" with "CT _{avg} " in formula. Remove "and" after definition of "GPRC _{avg} ". Insert definition of "CT _{avg} " as "means the average corporation tax rate from 1 April 2013 to 31 March 2021; and" |
| 1F.9 | Remove subscript "i" and " " from the formula. Replace "CT" with "CT _t " in the formula. Remove subscript "i" from all occurrences of "IP _{t-2,i} ", "OP _{t-2,i} ", "OP _{t-3,i} ", "LB _{t-2,i} " and "LV _{t-2,i} ". Insert a space between the words "relevant" and "Distribution" in the definition of "LB _{t-2} ". |
| 1F.11 | Replace "CT" with "CT _{avg} " in formula. Remove "and" after definition of "CC _{avg} ". Insert definition of "CT _{avg} " as "means the average corporation tax rate from 1 April 2013 to 31 March 2021; and" |
| 1F.13 | Correct typographical error in "Distription" by inserting "u" between the "b" and "t". |

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| 1F.14 | Remove subscript "i" in "ASV _{t,i} " and "LV _{t,i} ". |
| 1F, Appendix 4 | Replace "MWh" with "GWh" in heading of table. Multiply values in table by 100 so that they represent £/GWh. |
| 1H, Appendix 1 | Replace "Licensee" with "Distribution Network" in table heading. |
| 2A.17(b) | Replace text of sub-paragraph (b) with "ensure that the electronic name of the file is "GD1 PCFM" followed by "November 20XX" where 20XX represents the calendar year containing the month of November in the Formula Year t-1;" |
| 3A.10 | Replace lower case letter in "licensee" with upper case in definition of "SRAV". |
| 3D, Appendix 1 and 2 | Replace "Licensee" with "Distribution Network" in heading of each table. |
| 3F | Correct paragraph numbering from referencing "1A" to reference "3F". |
| 3F, Appendix 1 and 2 | Replace "Licensee" with "Distribution Network" in heading of each table. |
| 4A.11 (b) | Insert "'s" after first use of "Authority". Remove "'s" after last use of "Authority". |
| 4G.2 | Replace "Part D" with "Part E" in sub-paragraph (c). Replace "Part E" with "Part F" in sub-paragraph (d). |
| 4G.11 | Replace lower case letter in "licensee" with upper case. |
| 4H.11 (a) | Replace "(iii)" with "(ii)". |
| 4H.16 (a) | Replace "(iii)" with "(ii)". |